

Small Business Tax Preferences: Significant Legislative Proposals in the 110th Congress

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Summary

Some policy issues seem fixed on Congress's legislative agenda. One such issue is the taxation of small firms and its effects on their formation, performance, and growth. In the view of some lawmakers, the current federal tax burden on small firms, though smaller than it could be because of existing small business tax benefits, should be reduced further because it hinders their formation and retards their growth. Others find it difficult to justify on economic grounds additional tax relief for small business owners.

The federal tax code offers numerous benefits of varying importance to small firms, regardless of their lines of business. Most of these benefits take the form of deductions, exclusions and exemptions, credits, deferrals, and preferential tax rates.

A growing number of proposals to expand certain existing small business tax preferences, or create new ones, have been introduced in the 110th Congress. Several related bills are worth noting because they played a central role in congressional approval of legislation to increase the federal minimum wage.

Early in the current Congress, the House and Senate passed differing versions of legislation (H.R. 2) to raise the federal minimum wage from \$5.15 to \$7.25 over two years. The House version included no tax benefits intended to soften the impact of the increase on the financial condition of small firms, whereas the Senate version contained a set of such benefits and a package of revenue raisers intended to offset their revenue cost over 10 years.

With negotiations over moving to a conference on minimum wage legislation stalled, the House passed on March 23 a FY2007 supplemental appropriations bill (H.R. 1591) that included the minimum wage provisions from H.R. 2 and the business tax benefits from a bill it approved in February (H.R. 976). The Senate responded by passing an amended version of H.R. 1591 on March 29 that included the same minimum wage increase and an expanded version of the business tax benefits from H.R. 2. Differences between the two versions of H.R. 1591 led to the formation of a conference. A conference report (H.Rept. 110-107) was filed on April 24 that combined a set of business tax benefits with a package of revenue raisers intended to offset their estimated 10-year revenue cost of \$4.8 billion. The House approved the report on April 25, and the Senate did likewise the next day. But President Bush vetoed the bill on May 1, mainly because it included a timetable for removing U.S. combat troops from Iraq that he opposed.

The House and Senate then passed a second FY2007 supplemental appropriation bill (H.R. 2206) that omitted any such timetable but contained the same business tax benefits and revenue raisers. President Bush signed the measure on May 25.

This report describes significant proposals in the 110th Congress to create new tax benefits for small firms across all industries, or to enhance existing such benefits. It will be updated to reflect recent legislative activity.

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Some policy issues seem fixed on Congress's legislative agenda. A case in point is the taxation of small firms and its effect on their rate of formation, economic performance, and prospects for growth. Many bills to assist small firms through new or enhanced tax preferences were introduced in the past few Congresses—though relatively few of the proposals were enacted. The perennial congressional interest in small business taxation stems from the interplay of a combination of factors. Chief among them are the economic importance of small firms as a whole, the widely held belief that such firms are a major driving force behind technological innovation over time, and relentless pressure from the small business community for additional tax relief.¹

The powerful allure of small entrepreneurial firms and the considerable political clout of small business owners are reflected in the federal tax code, which contains a number of tax benefits for small firms across a broad range of industries. Nonetheless, some lawmakers say existing tax relief for small firms is inadequate; thus, they favor the adoption of further targeted reductions in the tax burden on small business owners. In the 110th Congress, a growing number of proposals to enhance certain existing small business tax preferences or create new ones are being considered. This report describes those proposals and discusses how they would change current tax law.

Current Small Business Tax Preferences

Firm size plays a significant role in the performance of certain industries and behavior of certain markets, but it exerts no similar influence on the organization of the federal tax code. The code makes no formal or explicit distinction between the taxation of small firms and all other firms. For example, there are no separate sections in the code for the tax treatment of small and large firms. Instead, current tax law contains numerous provisions, scattered throughout its many sections, that confer preferential treatment on small firms, but not on firms that many would regard as large.

Small business tax benefits differ in kind. Most take the form of deductions, exclusions and exemptions, credits, deferrals, and preferential tax rates. In combination, tax benefits such as these lower marginal effective tax rates on the income earned by small firms, relative to all other firms.

Still, existing small business tax benefits are not confined to those that shrink tax burdens. A few tax code provisions benefit small firms by reducing their cost of tax compliance. Research has indicated that this cost tends to be regressive with respect to firm size, which means that tax compliance costs typically claim a larger share of pre-tax income as firm size shrinks.² In addition, some other provisions grant tax relief to eligible small firms in exchange for the provision of certain fringe benefits (e.g., pension plans) to employees.

Not only does the federal tax code make no formal distinction between the taxation of small firms and all other firms, it also incorporates no uniform definition of a small firm, nor any consistent criteria for identifying the firms that qualify for current small business tax benefits. As a consequence, eligibility criteria can vary from one such benefit to the next. For example, some

¹ According to the Small Business Administration (SBA), firms with fewer than 500 employees account for half of private-sector employment and generate more than half of non-farm gross domestic product. See Small Business Administration, Office of Advocacy, *Frequently Asked Questions* (Washington: June 2006), available at <http://app1.sba.gov/faqs/faqIndexAll.cfm?areaid=24>.

² Joel Slemrod, "Small Business and the Tax System," in *The Crisis in Tax Administration*, Henry J. Aaron and Joel Slemrod, eds. (Washington: Brookings Institution Press, 2004), p. 70.

tax benefits are available only to firms with annual gross receipts below a certain level, while other benefits are limited to firms beneath a certain asset or employment size. Some may find it surprising that among the eligibility criteria for current small business tax preferences, employment size is seldom found. By contrast, the Small Business Administration relies heavily on employment size to collect and publish data on the economic condition of small business, and to provide support to small business through the programs it administers.³

Existing small business tax benefits also differ in scope and economic importance. Some apply to small firms in specific industries only (e.g., life insurance, banking, and energy production and distribution), while others can affect nearly every small firm, regardless of industry affiliation. Those benefits with the broadest reach outside agriculture include

- the rules governing the taxation of passthrough entities (including subchapter S corporations),
- graduated corporate income tax rates,
- the expensing allowance for certain depreciable business assets,
- the exemption of small corporations from the corporate alternative minimum tax,
- the amortization of business start-up costs,
- cash-basis accounting,
- the exclusion of gains on certain small business stock,
- and the tax credit for a portion of the start-up costs of pension plans offered by certain small firms.⁴

This report deals only with small business tax benefits with such a reach.

All small business tax benefits, except those intended to ease the tax compliance burden for small firms, entail a loss of federal revenue—at least in the short run. But owing to insufficient data and disagreement among budget analysts over which provisions in the tax code rightfully constitute small business tax benefits, it is difficult to derive an accurate and widely accepted estimate of the revenue cost of existing small business tax preferences. Nevertheless, recent estimates by the Joint Committee on Taxation and the Treasury Department of the revenue loss caused by a variety tax expenditures indicate that the cost exceeded \$8 billion in FY2005.⁵

Legislation Enacted in the 109th Congress

While many bills with provisions intended to enhance or create new small business tax benefits were introduced in the 109th Congress, only two were enacted: the Tax Increase Prevention and

³ CRS Report RL33243, *Small Business Administration: A Primer on Programs*, by N. Eric Weiss.

⁴ For a description of existing small business tax preferences and the economic arguments that have been raised for and against them, see CRS Report RL32254, *Small Business Tax Benefits: Overview and Economic Rationale*, by Gary Guenther.

⁵ For FY2005, the projected combined revenue loss for seven of the most important small business tax preferences is \$7.960 billion. This estimate applies to the following preferences: partial exclusion of capital gains on small business stock; ordinary income treatment of losses on the sale of eligible small business corporation stock; amortization of business start-up costs; tax credit for start-up costs of small business pension plans; cash accounting for non-agricultural firms; graduated tax rate structure for corporations; and expensing allowance for small business investment in eligible assets. See U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, JCS-1-05 (Washington: GPO, 2005), table 1; and Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006* (Washington: GPO, 2005), table 19-2.

Reconciliation Act of 2005 (TIPRA, P.L. 109-222) and the Pension Protection Act of 2006 (PPA, P.L. 109-280).

Among other things, TIPRA extended for two years (through 2009) the enhanced small business expensing allowance enacted under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and extended through 2007 by the American Jobs Creation Act of 2004 (AJCA).

The PPA permanently extended some of the provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 dealing with pensions, including a non-refundable tax credit for a portion of the start-up costs for qualified pension plans offered by eligible small employers.

Significant Legislative Proposals in the 110th Congress

A growing number of proposals to enhance existing small business tax preferences or create new ones have been introduced in the current Congress. They vary in scope, potential economic effects, revenue cost, and the support they command among the Republican and Democratic leaders in the House and Senate.

Several such proposals merit discussion because they played a central role in congressional approval of legislation to increase the federal minimum wage. They are H.R. 2/S. 349, H.R. 976, H.R. 1591, and H.R. 2206 (P.L. 110-28).

Legislation to Increase the Federal Minimum Wage

The House took the first major step in enacting an increase in the federal minimum wage by passing H.R. 2 on January 10, 2007. H.R. 2 would have increased the federal minimum wage from its current level of \$5.15 to \$7.25 over two years, but it would have done so without extending tax benefits to small firms likely to be affected by the increase.

The Senate responded by passing an amended version of H.R. 2 on February 1. Its version of the bill replaced the text of the House-passed version with the text of S. 349, which was introduced by Senator Max Baucus and unanimously approved by the Senate Finance Committee (S.Rept. 110-1) on January 17. S. 349 paired the same increase in the federal minimum wage with a package of tax benefits intended to mitigate the impact of the increase on the financial conditions of small firms. In addition, the measure would have offset the estimated revenue cost of those benefits (\$8.3 billion from FY2007 to FY2016) with a package of revenue raisers, none of which would have disproportionately affected small firms. For Senate Democratic leaders, a chief motive for combining an increase in the minimum wage with a package of small business tax benefits was to secure the 60 votes needed for passage of the measure in the Senate.⁶ Republican leaders in the Senate and House had said that they would support legislation increasing the minimum wage only if it included significant targeted tax relief for small firms.

Despite news reports to the contrary, not all of the six tax preferences included in the Senate-passed version of H.R. 2 would have benefitted small firms exclusively, or even predominantly. But some of them would have benefitted small firms more than others. Three of the preferences would have bestowed most of their benefits on such firms: a one-year extension of the expensing allowance, an increase in the threshold for using cash accounting methods, and a modification of

⁶ Kurt Ritterpusch and Heather Rothman, "Baucus Outlines \$10 Billion in Tax Breaks For Small Firms; Offsets Not Announced," *Daily Report for Executives*, BNA, January 11, 2007, p. GG1.

certain rules governing the formation and taxation of subchapter S corporations. But the measure also included two tax preferences that could have benefitted firms of all asset or employment sizes: namely, (1) an extension of the straight-line 15-year depreciation life for restaurant and leasehold improvements through March 2008 and an expansion of the property eligible for this tax treatment to include comparable improvements in retail property and new restaurant construction; and (2) an extension of the work opportunity tax credit (WOTC) for five years (through 2012), and an expansion of the credit to include veterans disabled after September 11, 2001, and certain high-risk youths.

In a bid to pave the way for a conference with the Senate over H.R. 2, the House passed H.R. 976 on February 16. Though the measure did not address the minimum wage, it contained a more modest package of tax benefits targeted at small firms than the package of business tax benefits in the Senate-passed version of H.R. 2, and it would have offset their estimated revenue cost (\$1.3 billion from FY2007 to FY2016) with a package of revenue raisers that also differed in kind and size from the revenue raisers in H.R. 2. Once again, none of the revenue raisers in H.R. 976 would have disproportionately affected small firms.

H.R. 976 would have provided five business tax benefits: (1) a one-year extension of the WOTC (through 2008), an expansion of the credit to include disabled veterans, and an increase from 25 to 40 in the age limit for eligible employees living in empowerment zones and enterprise and renewal communities; (2) a one-year extension of the expensing allowance (through 2010), an increase in the maximum allowance to \$125,000 and the phaseout threshold to \$500,000 starting in 2007, and an indexation of both amounts for inflation; (3) a freeze in the minimum wage at the current level of \$5.15 for the purpose of determining the tax credit that employers in the restaurant business may claim for federal payroll taxes paid on employee tips above the federal minimum wage; (4) a permanent waiver of the limitations under the individual and corporate alternative minimum tax on claims for the WOTC and the business tax credit for federal payroll taxes paid on employee tips; and (5) a revision of current tax filing requirements to allow a married couple who owns an unincorporated business to file as a sole proprietorship, instead of a partnership, without incurring a penalty, and to allow both spouses to receive credit for payroll taxes paid. While many small firms would be likely to benefit from each provision, only the proposed changes to the expensing allowance and tax filing requirements would have aimed most or all of their benefits at such firms.

With negotiations between House and Senate leaders over moving to a conference on H.R. 2 or H.R. 976 stalled, House Democratic leaders, trying to find an expeditious way to break the impasse, added the minimum wage provisions from H.R. 2 and the business tax provisions and revenue raisers from H.R. 976 to a bill (H.R. 1591) to provide supplemental FY2007 appropriations. The House passed the measure on March 23. Facing pressure to act quickly, the Senate passed its version of the bill on March 29. It included the minimum wage provisions from H.R. 2 and a package of business tax benefits, whose estimated revenue cost would be offset by a package of revenue raisers. Both packages differed somewhat from the business tax benefits and revenue raisers included in H.R. 2. The Senate-passed version of H.R. 1591 contained the same business tax benefits as H.R. 2 with two exceptions. First, H.R. 1591 would have extended the straight-line 15-year cost recovery period for leasehold and restaurant improvements through 2008, while H.R. 2 would have extended that treatment only through March 2008. Second, H.R. 1591 would have expanded the WOTC and expensing allowance under IRC Section 179 to apply to “rural renewal counties,” which were defined as counties outside metropolitan statistical areas that experienced a net population loss either between 1990 and 1994 or between 1995 and 1999; H.R. 2 had no similar provision. The estimated revenue cost of the business tax benefits in the Senate-passed version of H.R. 1591 was \$12.6 billion from FY2007 through FY2016.

House and Senate leaders agreed to a conference to resolve the differences between the two versions of H.R. 1591. On April 24, House and Senate negotiators filed a conference report (H.Rept. 110-107) that included a package of business tax benefits with a projected revenue cost of \$4.8 billion from FY2007 through FY2017 and a package of revenue raisers designed to offset that cost. The House approved the report on April 25, and the Senate did likewise on the following day. But President Bush vetoed the measure on May 1, mainly because it contained a timetable for withdrawing U.S. combat troops from Iraq that he deemed unacceptable. An effort to override the President's veto failed in the House on May 2.

A second bill to provide supplemental appropriations for FY2007 (H.R. 2206) was passed by the House on May 10 and by the Senate on May 17. It omitted any timetable for withdrawing troops from Iraq but included the same packages of business tax benefits and offsetting revenue raisers from the version of H.R. 1591 vetoed by the President. President Bush signed the measure on May 25. The new law included the following small business tax benefits: (1) an increase in the maximum expensing allowance to \$125,000 and the phaseout threshold for the allowance to \$500,000 in 2007, and an indexation of both amounts for inflation in 2008 through 2010; (2) modifications in some of the rules governing subchapter S status⁷; and (3) a change in tax filing requirements so that married couples who jointly own an unincorporated business may file as a sole proprietorship rather than a partnership. None of the revenue raisers included in the new law was likely to have a disproportionate effect on small firms.

Other Proposals

Four other legislative proposals are worth noting because they were introduced by members of the House and Senate with significant influence over the legislative agenda for small business in the 110th Congress.

One such proposal is H.R. 324, which was introduced on January 9, 2007, by Representative McKeon, with the backing of House Republican leaders. The measure has three key elements: (1) a gradual rise in the federal minimum wage; (2) three tax preferences intended to benefit small business owners likely to be affected by an increase in the minimum wage; and (3) a removal of the legal obstacles to the creation of association health plans. Only one of the three tax preferences targets most of its benefits at small firms: a one-year extension (through the end of 2010) of the enhanced small business expensing allowance enacted under JGTRRA. The other two—a reduction in the period for recovering the cost of new restaurant buildings through depreciation allowances from 39 years to 15 years and a repeal of the surtax for the federal unemployment trust fund enacted in 1976—could benefit firms of all sizes. It seems reasonable to maintain that H.R. 324 is intended, in part, to set forth some of the key conditions that must be satisfied before the Republican leadership could accept an increase in the federal minimum wage.

⁷ The new law made six changes in the rules governing the tax treatment of subchapter S corporations. First, it eliminated gains from the sale or exchange of stock or securities held by an S corporation as a source of passive investment income. Second, it exempted shares of stock held by bank directors from the rules governing the tax treatment of S corporations. Third, it allowed banks that stop using the reserve method of accounting for bad debts in their first tax year as an S corporation to make the needed adjustments to income under IRC section 481 during the final year they operated as C corporations. Fourth, it modified the tax treatment of the sale of an S corporation's interest in any of its qualified subchapter S subsidiaries. Fifth, it required all corporations not organized as S corporations in their first tax year after 1996 to reduce their accumulated earnings and profits at the beginning of the 2008 tax year by any accumulated earnings and profits they had in a tax year before 1983 when they operated as an electing small business corporation under subchapter S. And sixth, it allowed electing small business trusts to deduct any interest paid or accrued on debt used to acquire S corporation stock in computing the taxable income of their S portions.

Representative Nadia Velazquez, chairwoman of the House Committee on Small Business, introduced H.R. 46 in early January 2007. Among other things, the bill would allow buyers of eligible small firms to amortize over five years up to \$5 million in qualified intangible assets, increase the capital gains exclusion for the sale of eligible small business stock from 50% to 62.5%, raise the minimum home office deduction to \$2,500, and expand the maximum number of shareholders for subchapter S corporations to 150.

Senator John Kerry, chairman of the Senate Committee on Small Business and Entrepreneurship, introduced a bill (S. 99) that would create a partially refundable tax credit for certain small firms that provide health insurance coverage to employees. The credit would range from 50% of qualified health insurance expenses for employers with fewer than 10 such employees, to 20% for employers with 25 to 49 employees. Firms with 50 or more employees would be ineligible for the credit.

Senator Max Baucus, chairman of the Senate Finance Committee, introduced a bill (S. 41) that seeks to bolster the domestic climate for technological innovation. While its central focus is improving the efficacy of the research tax credit under IRC Section 41, the bill includes a new non-refundable personal tax credit to encourage an increased flow of equity investment in small firms that invest heavily in research and development (R&D). The credit would be equal to 5% of the amount paid to a qualified research entity for an equity stake. It could be claimed for the first five years an investor owns stock in such an entity. A qualified research entity is defined as any domestic corporation or partnership that provides “investment capital for qualifying small business innovation companies.”

An explanation of how these and other legislative proposals would change current tax law follows. The discussion is divided between proposals to enhance current small business tax benefits and proposals to establish new ones.

Current Small Business Tax Benefits

Expensing Allowance Under IRC Section 179

Under IRC Section 179, business taxpayers buying qualified assets may write off as a current expense some or all of their cost (depending on the amount) in the year they are placed into service. Certain conditions must be met in order to claim this expensing allowance. For the most part, the qualified assets consist of machinery and equipment, including motor vehicles. Taxpayers unable to claim the allowance may recover the cost of qualified assets over longer periods through allowable depreciation deductions.

Expensing is the most accelerated form of depreciation. As a result, it lowers the cost of capital, simplifies tax accounting, and can boost the cash flow of firms that take advantage of it.⁸

In 2007, the maximum allowance for most firms is set at \$125,000. From 2008 through 2010, this amount is indexed for inflation. Beginning in 2011 and beyond, the maximum allowance will drop to \$25,000, its level before the enactment of JGTRRA.

The allowance begins to phase out, dollar for dollar, when the total cost of qualified assets placed in service in the 2007 tax year exceeds a threshold of not less than \$500,000. This amount is also indexed for inflation in 2008 to 2010. Assuming no change in current law, the phaseout threshold will fall to \$100,000 in 2011 and beyond, its level before the enactment of JGTRRA.

⁸ CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by Gary Guenther.

So in 2007, firms that purchase and place in service \$625,000 or more in qualified assets may claim no expensing allowance for those investments. Instead, the cost of the assets may be recovered over a longer period through allowable depreciation methods.

H.R. 324, H.R. 1012, S. 439/H.R. 2 (as amended by the Senate), and S. 299. Each bill would extend the current expensing allowance through 2010, after which the maximum allowance would fall to \$25,000 and the phaseout threshold to \$100,000, with no indexation for inflation.

H.R. 976/H.R. 1591/H.R. 2206 (P.L. 110-28). The bills would extend the current expensing allowance by one year (through 2010), increase the maximum expensing allowance to \$125,000 and the phaseout threshold to \$500,000, starting in 2007, and index both amounts for inflation. Beginning in 2011 and thereafter, the allowance would fall to \$25,000 and the phaseout threshold to \$200,000, with no adjustment for inflation. President Bush signed H.R. 2206 on May 25.

H.R. 1797. The bill would permanently increase the maximum expensing allowance to \$200,000 and the phaseout threshold to \$800,000, as of January 1, 2007. It would also permanently index both amounts for inflation, add off-the-shelf business software to the assets eligible for the allowance, and modify the phaseout of the allowance so that it is reduced by \$0.50 for each dollar of spending on qualified assets above the phaseout threshold.

S. 14/S. 1197. The bill would permanently extend the features of the expensing allowance before it was modified by P.L. 110-28.

S. 269. The bill would raise the maximum expensing allowance to \$200,000 and the phaseout threshold to \$800,000, and index both amounts for inflation, starting in 2007 and thereafter. It would also make purchases off-the-shelf software for business use permanently eligible for the allowance, beginning in 2010.

Cash-Basis Accounting

Under IRC Section 446, business taxpayers have some flexibility in choosing the method of accounting they use to compute taxable income. Nonetheless, regardless of which method of accounting a firm uses for tax purposes, it must clearly reflect all relevant items of income.

Two methods of financial accounting are widely used in the private sector: cash basis and accrual basis. Under the former, which is generally the preferred method for self-employed individuals, income is recorded when it is received in the form of cash or its equivalent, and expenses are recorded when they are paid, regardless of when income is actually earned and expenses actually incurred. Under accrual-basis accounting, by contrast, income and expenses are recorded when the transactions giving rise to them are completed or nearly completed, regardless of when cash or its equivalent is received or paid. In general, a company using accrual accounting records income when its right to receive it is legally established, and expenses when the amounts are fixed and its liability for them is legally established.

Each accounting method has its advantages. Cash accounting is simpler to administer, but accrual accounting often yields a more accurate measure of a firm's economic income, as it does a better job of matching income with expenses. In addition, firms using the cash method have more control over when income is recognized for tax purposes.

Under IRC Section 448, C corporations, partnerships with C corporations as partners, trusts subject to taxation on unrelated business income, and legal tax shelters are barred from using cash accounting. An exception is made for firms engaged in farming or the commercial cultivation of trees and firms organized as personal service corporations. This exception also applies to C

corporations and partnerships with C corporations as partners, when those entities have average annual gross receipts in the three previous tax years not in excess of \$5 million.

Under IRC Section 471, the IRS may require firms to maintain inventories using the accrual method, to make sure that the accounting method used for tax purposes clearly reflects all relevant items of income. This requirement is generally applied to firms whose income hinges on the production, purchase, or sale of merchandise. Nevertheless, an exception is made for firms in this position whose average annual gross receipts in the three previous tax years do not exceed \$1 million: they are free to use the cash method.

S. 269, S. 347, S. 349/H.R. 2 (as amended by the Senate). The bill would allow C corporations and partnerships with corporate partners whose average annual gross receipts in the three previous tax years do not exceed \$10 million to use the cash method of accounting for tax purposes. It would also raise the threshold for using cash accounting to \$10 million for firms that otherwise would be required to maintain inventories using the accrual method. Starting in 2008 or 2009 and thereafter, the \$10 million threshold would be indexed for inflation.

Subchapter S Corporations and Partnerships

Under the federal tax code, firms have the option of being organized as a subchapter S corporation.⁹ S corporations are passthrough entities that are treated like partnerships for federal tax purposes. Unlike C corporations, S corporations do not pay an entity-level tax like the corporate income tax. Instead, their items of income (or loss) are passed on (or through) to shareholders, who must account for them separately on their individual income tax returns. This attribution of income occurs even if the S corporation retains its earnings, instead of distributing them to shareholders. To avoid double taxation of income when a shareholder sells or otherwise disposes of his or her S corporation stock, each shareholder's basis in the stock is increased by any amount included in his or her income in a tax year, or decreased by any loss that is taken into account. A shareholder's loss may be deducted on his or her individual income tax return only to the extent of his or her basis in the stock or debt of the S corporation.

While S corporations generally are not taxed on the income they earn, they are subject to taxation at corporate tax rates on passive investment income in excess of 25% of their gross receipts. S corporations also are subject to a tax on accumulated earnings and profits under IRC Section 1375.

Not all firms are eligible for subchapter S status, only those that qualify as a small business corporation. Such a corporation is defined as a domestic corporation with no more than 100 qualified shareholders and no more than one class of stock. Qualified shareholders are estates, certain trusts and tax-exempt organizations, and individuals who are residents or citizens of the United States. Families have the option of being treated as a single shareholder. Partnerships and C corporations cannot serve as S corporation shareholders.

Firms that meet the requirements for classification as a small business corporation do not automatically gain subchapter S status. To gain that status, a qualifying corporation must elect to do so, and all shareholders at the time of the election must consent to the decision. A corporation can lose its S status by failing to continue to meet all the criteria for a small business corporation, or by having excess passive investment income and accumulated earnings and profits

⁹ Business enterprises may be organized for tax purposes as some kind of passthrough entity or a C corporation, which is subject to an entity-level tax on its income. The major categories of passthrough entities are partnerships (including limited liability companies), S corporations, and sole proprietorships. Most firms operate as some kind of passthrough entity. In 2004, the most recent year for which data are available, sole proprietors filed 20.6 million federal tax returns; S corporations, 3.6 million returns, partnerships, 2.5 million returns, and C corporations, 2.0 million returns. See Internal Revenue Service, *Statistics of Income Bulletin: Fall 2006* (Washington: 2006), pp. 342-346.

at the end of the year for three consecutive tax years. Once a firm loses its S status, it (or any successor) must wait five years before it can elect that status again.

For many investors and business owners, a key advantage of seeking S status, rather than C status, is the avoidance of double taxation of business income. In 2007, the maximum individual tax rate is the same as the maximum corporate tax rate: 35%. So avoiding one layer of taxation can have its appeal, especially for individuals taxed at the highest marginal rates. But other tax considerations might lessen this appeal. For example, S corporation earnings passed through to shareholders are not considered dividends, and thus are not taxed at the current 15% rate for dividends. By contrast, C corporation earnings distributed to shareholders as dividends are taxed at that rate.

Another important advantage of S status over C status is that shareholders of S corporations have greater latitude to take advantage of corporate losses. While a C corporation may use net operating losses only to offset income in the last two or next 20 tax years, S corporation shareholders can use corporate losses immediately to offset income from other sources. The ability to use losses immediately is especially valuable to shareholders during the early years of a business, when profits may be meager and shareholders' investment in the business is large enough to allow them to use any losses.

S. 349/H.R. 2 (as amended by the Senate). The bill would make six changes of varying significance in the rules governing the taxation of S corporations. On the whole, the changes seem intended to create a more level playing field among the tax treatment of S corporations, limited liability companies, and partnerships, and to modernize outdated rules and restrictions.¹⁰

One provision of the bill would eliminate gains from the sales or exchanges of stock or securities as a source of passive investment income for S corporations.

Another provision would clarify the status of shares of bank stock owned by directors of banks operating as S corporations. Under the provision, the bank stock would not be treated as a second class of stock, as it currently is; the directors holding the stock would not be treated as a S corporation shareholder, as they currently are; the stock would be disregarded in allocating items of income and loss among shareholders; and the stock would not be considered in determining whether a bank operating as an S corporation holds 100% of the stock of a qualified subchapter S subsidiary.

The bill would also allow banks that convert to S status and wait until the first year of S status to discontinue the reserve method of accounting for bad debts to declare all adjustments from the change in accounting method as income for the year before the conversion, and to pay tax on that income. Such a provision would prevent the transfer of a tax burden to the shareholders that occurs under current law.

Another provision would allow non-resident aliens to become beneficiaries of an electing small business trust (ESBT) that owns stock in an S corporation. The change would enable families who control an S corporation to expand its access to equity capital by inviting family members who are not U.S. citizens and live abroad to participate in the business as shareholders.¹¹

The bill would also modify the tax treatment of the sale of stock in qualified S corporation subsidiaries by the parent S corporation. Under the provision, the sale would be regarded as a sale

¹⁰ Stephen Joyce, "Minimum Wage Bill Amendment Seen Giving Favorable Tax Treatment to S Corporations," *Daily Report for Executives*, BNA, January 25, 2007, p. G-13.

¹¹ *Ibid.*, p. G-13.

of an undivided interest in the subsidiary, followed by a transfer of all the assets to a new corporation that is subject to the rules of IRC Section 351.

Another provision concerns some C corporations that once were organized as S corporations. It would allow a C corporation that was not organized as an S corporation after 1996 to reduce its accumulated earnings and profits at the start of the first tax year after the enactment of the provision by any accumulated earnings and profits it had in the final tax year before 1983, when it was organized as an S corporation.

H.R. 46. The bill would raise the maximum number of qualified shareholders for an S corporation from 100 to 150.

S. 270. The bill would allow S corporations, partnerships, and start-up firms more flexibility than they have under current tax law in selecting a tax year. Current law requires S corporations and partnerships to adopt a tax year that ends on December 31. Under S. 270, qualified firms could select a tax year that ends on the last day of any of the months from April through November. To qualify for this exception, a firm must be an S corporation or partnership with average annual gross receipts in the past three tax years of \$5 million or less, or a start-up firm.

New Small Business Tax Preferences

Tax Credits for Employee Health Benefits

Current Law

Current federal tax law offers no tax credits to employers that provide health insurance to employees. Instead, there are a variety of tax incentives to encourage individuals to purchase health insurance, either on their own in the individual market or through their employers in the group market.

Employees pay no federal income or payroll taxes on employer contributions to health and accident plans in which they participate. This exclusion also applies to certain health benefits received by employees who participate in so-called cafeteria plans operated by employers. In addition, many employers offer health benefits to employees through flexible spending accounts (FSAs). Under such an arrangement, an employee chooses a benefit limit at the start of a calendar year and draws on the funds in the account to pay for medical expenses not covered by employer health plans. FSAs are funded through a combination of wage or salary reductions and employer contributions, both of which are exempt from income and payroll taxes.

Self-employed individuals may deduct the total amount paid for health insurance for themselves and their spouses and dependents from their taxable income. These payments, however, are not exempt from payroll taxes.

Individual taxpayers who itemize on their tax returns are allowed to deduct the total amount paid for qualified medical care (including health insurance premiums) for themselves and their spouses and dependents above 7.5% of their adjusted gross income.

Under the Trade Adjustment Assistance Reform Act of 2002, certain individuals may claim what is known as the health coverage tax credit (HCTC). The HCTC is a refundable credit equal to 65% of the amount paid for qualified health insurance by the following individuals: those receiving trade adjustment allowances (or those who would be eligible to do so if they had not exhausted their regular unemployment benefits); those eligible for the alternative trade

adjustment assistance program; and those over age 55 who receive pension benefits through the Pension Benefit Guaranty Corporation.

Finally, under IRC Section 223, eligible individuals with qualified high-deductible health insurance plans (and no other health plan, with certain exceptions) may establish health savings accounts (HSAs). In 2007, qualified plans have minimum deductibles of \$1,100 for single coverage and \$2,200 for family coverage, and a limit on out-of-pocket medical expenditures of \$5,500 for single coverage and \$11,000 for family coverage. An HSA is a tax-exempt trust or custodial account. Contributions to a HSA by, or on behalf of, an eligible individual may be deducted from his or her taxable income. Employer contributions to these accounts are excluded from income and payroll taxes. There are limits on annual contributions to a HSA: in 2007, the limits are \$2,850 for single coverage and \$5,650 for family coverage. Withdrawals from HSAs to pay for qualified medical expenses are not taxed. Excluded from these expenses are health insurance premiums, with some exceptions. Withdrawals from HSAs not used to cover qualified medical expenses are subject to income taxation and a 10% tax penalty.

H.R. 1802. The bill would create a new permanent refundable tax credit under IRC Section 36 for eligible small firms that offer health insurance to employees. The credit would be equal to 60% of the total amount paid for qualified employee health benefits by firms that employ 25 or fewer individuals, or 40% of the total amount paid for the same benefits by firms that employ 26 to 100 individuals. Firms with more than 100 employees would be ineligible for the credit.

Eligible employers could claim no credit under any of the following circumstances: (1) an employer covers less than 65% of the cost of qualified employee health benefits; (2) the employer's health plan covers less than 75% of its workforce; (3) the employer's health plan offers fewer benefits than any of its previous health plans; or (4) the share of their cost covered by an employer falls below the share it covered under any previous health plan.

S. 99. The bill would establish a new permanent refundable tax credit (IRC Section 45O) for qualified small employers that offer health benefits to eligible employees. The credit would depend on a qualified employer's employment size. Specifically, it would equal 50% of employer spending on health insurance coverage, up to a limit per employee of \$4,000 for single coverage and \$10,000 for family coverage, for qualified firms with fewer than 10 qualified employees. The credit rate would drop to 25% for qualified firms with 10 to 24 such employees, and to 20% for qualified firms with 25 to 49 such employees.

To qualify for the credit, a firm would have to offer health insurance to all qualified employees, pay for at least 50% of the cost of that insurance, have average annual gross receipts of \$5 million or less in the past three tax years, and employ an average of 2 to 49 qualified individuals in the previous tax year. Start-up firms could qualify for the credit by demonstrating that they are likely to employ an average of 2 to 49 qualified individuals in the current tax year.

A qualified employee (or individual) is defined as a current employee who meets two criteria. First, such an employee is not eligible for health insurance coverage through a health plan offered by a spouse's employer, or through any federal health plan (e.g., Medicare, Medicaid, or military health plans). Second, he or she receives no more than \$50,000 in compensation from a qualified employer in a calendar year. This amount would be indexed for inflation.

S. 158. The bill would create a new permanent non-refundable tax credit (IRC Section 45N) for qualified small employers that offer health insurance to eligible employees, beginning in 2008. The credit would be equal to 50% of qualified employee health insurance expenses for employers with fewer than 10 qualified employees, and 30% for employers with 10 to 25 qualified employees. For each qualified employee, there would be a limit on such expenses of \$2,000 for single coverage and \$4,000 for family coverage. Eligible employers could claim no credit when

over 20% of their employees qualify as “highly compensated” under IRC Section 414(q). The credit would become part of the general business credit under IRC Section 38—and thus subject to its limitations.

To claim the credit, an employer would have to offer health insurance to all qualified employees, pay for a minimum of 50% of the premium for that coverage, and have an average of 25 or fewer qualified employees in one of the two previous calendar years. New employers could qualify for the credit by demonstrating that they expect to have no more than 25 qualified employees in the current calendar year.

The bill defines qualified employees as employees whose annual wages total \$5,000 or more.

Amortization of Intangible Assets

Current Law

Business acquisitions entail a transfer of assets, both tangible and intangible, from the seller to the buyer. Under IRC Section 197, firms may recover the cost of qualified intangible assets they acquire by amortizing that cost over 15 years, beginning in the month when the assets are acquired. In the case of qualified intangible assets, this treatment applies, regardless of the actual useful life of such an asset. No other depreciation allowances may be claimed on intangible assets subject to this treatment. Amortization is equivalent to straight-line depreciation in that equal amounts of a taxpayer’s basis in an asset are deducted in each year of the cost-recovery period.

The cost of the following intangible assets may be amortized over 15 years: “goodwill; going-concern value; work force in place; an information base; any patent, copyright, formula, process, design, pattern know-how, format, or similar item; any customer-based intangible; any supplier-based intangible; any license, permit, or other right granted by a governmental unit or agency; any covenant not to compete entered into in connection with the acquisition of a trade or business; and any franchise, trademark, or trade name.”

H.R. 46. The bill would carve out a permanent exception under IRC Section 197 for the depreciation of intangible assets acquired from certain small firms. Specifically, it would allow business taxpayers to amortize over five years—rather than the 15 years allowed under current tax law—up to \$5 million of the cost of intangible assets they acquire when they purchase firms whose average annual gross receipts in the three tax years before the acquisition do not exceed \$5 million. A shorter period for cost recovery might make it easier for owners of small firms with relatively high amounts of intangible assets to sell them, as it would reduce the tax burden of the buyer in the first few years after the acquisition.

Partial Exclusion of Capital Gains from the Sale of Qualified Small Business Stock

Current Law

IRC Section 1202 permits non-corporate taxpayers (including partnerships and S corporations) to exclude 50% of any gain from the sale or exchange of qualified small business stock (QSBS) issued after August 10, 1993 and held for more than five years. QSBS can be issued only by a C corporation whose assets do not exceed \$50 million at the time the stock is issued, or by specialized small business investment companies licensed under the Small Business Investment Act of 1958. At least 80% of the assets of entities issuing such stock must be involved in the active conduct of one or more qualified trades or business during “substantially all” of the

five-year holding period for the stock. There is a cumulative limit on the gain from stock issued by a qualified entity that may be excluded: the gain that may be excluded in a tax year is limited to the greater of 10 times the taxpayer's adjusted basis in the QSBS issued by a qualified entity and disposed of in the year, or \$10 million, less any gains excluded by the taxpayer in previous tax years.

Taxpayers may exclude 60% of the gain on QSBS issued by qualified business entities that conduct all their business within federal empowerment zones, as defined under IRC Section 1397C.

The provision is intended to encourage private investment in small start-up firms that may have trouble raising funds in debt and equity markets.

H.R. 46. The bill would permanently increase the share of capital gains on the sale or exchange of QSBS that may be excluded under IRC Section 1202 to 62.5% for QSBS issued by qualified entities operating outside empowerment zones, and to 75% for QSBS issued by qualified entities operating within such zones.

Tax Credit for Qualified Equity Investment in Eligible Small Firms

Current Law

Current tax law offers no tax credit for equity investment in firms of any size. But there are several tax incentives to encourage such investment in small start-up firms that may have difficulty raising adequate funds in debt and equity markets. Under IRC Section 1202, non-corporate taxpayers may exclude 50% of any capital gains they realize from the sale or exchange of qualified small business stock. Under IRC Section 1242, taxpayers who invest in small business investment companies (SBICs) may deduct from their ordinary income any losses they incur from the sale or exchange or loss of value of SBIC stock they own; there is no limit on the size of the deductible loss. In the absence of such a provision, individual taxpayers who realize a loss on the sale or exchange of SBIC stock would be able to deduct the loss from any capital gains they have, or from no more than \$3,000 of ordinary income, in a single tax year. And under IRC Section 1244, individual taxpayers may deduct from ordinary income any loss they realize from the sale or exchange of stock issued after November 6, 1978, by firms whose contributions to capital and paid-in surpluses did not exceed \$1 million when the stock was issued.

H.R. 578. The bill would create a new non-refundable tax credit under IRC Section 45O for equity investment in certain small firms. The credit would be equal to 25% of each qualified equity investment made by a qualified investor in a tax year, up to a limit of \$500,000. A qualified investor could invest no more than \$250,000 in a single qualified small business in a tax year.

To qualify for the credit, an investor would have to be an any individual or partnership that qualifies as an "accredited investor" under regulations established by the Securities and Exchange Commission.

Equity investments would qualify for the credit if they were to involve the exchange of cash or its equivalents for the stock of, or an ownership interest in, a qualified small business. Under the bill, such a business is defined as a firm that is based in the United States and meets the appropriate size standard set by the Small Business Administration under Section 3 of the Small Business Act.

An investor would be able to claim the credit for an equity investment in a qualified small business only if the business uses at least 80% of its assets in the active pursuit of a qualified trade or business during "substantially all" of the period the investor holds an equity stake in the

enterprise. A qualified trade or business would have the same meaning as a qualified trade or business for the partial exclusion of capital gains on the disposition of qualified small business stock under IRC Section 1202. Activities related to research and development would meet the test of a qualified trade or business for the credit.

S. 41/1712. The bills would establish a complicated new non-refundable tax credit under IRC Section 45N for individuals who invest indirectly in small research-intensive companies. The credit would be equal to 5% of the amount invested in a so-called “qualified research entity” on a “credit allowance date.” Credit allowance dates would be the date on which an initial equity investment is made and the next four anniversaries of that date. No credit could be claimed for a qualified equity investment beyond the fourth tax year after it is first made.

A qualified research entity is defined as any domestic corporation or partnership that meets two criteria. First, its “primary mission is serving, or providing investment capital for, qualifying small business innovation companies.” Second, the entity is dedicated to maintaining “accountability to engineers, scientists, and other research-related professionals through their representation on any governing board of the entity.” A qualifying small business innovation company is defined as any corporation (for-profit or not-for-profit) or partnership whose gross receipts do not exceed \$10 million, whose gross assets do not exceed \$25 million, and that devotes at least 50% of its “gross expenditures” to research that qualifies for expensing under IRC Section 174.

To qualify for the credit, an individual would have to purchase the stock of a qualified research entity “at its original issue (directly or indirectly through an underwriter) solely in exchange for cash.” In addition, the entity must use “substantially all of such cash ... to make qualified research investments.” The “substantially all” standard would be considered met if the entity were to invest “at least 85% of (its) gross assets” in qualified research investments. A qualified research investment is defined as equity investment in or loan to a qualifying small business innovation company of no more than \$10 million in a single tax year, or the purchase from another qualified research entity of any loan it has made to such a company.

Two additional rules would govern the availability of the credit. First, there would be annual limits on the aggregate credit that could be claimed in 2007 through 2011. Specifically, the aggregate credit could not exceed \$500 million in 2007, \$750 million in 2008 and 2009, and \$1 billion in 2010 and 2011. It is not clear from the language of the bill what would happen in 2012 and thereafter. Second, the Treasury Secretary would have the authority to allocate these annual limits among qualified research entities. No single entity could receive an allocation of more than \$25 million in a single tax year. In making the allocations, the Secretary would be required to give priority to any entity “with a record of having successfully provided capital or technical assistance to qualifying small business innovation companies.”

Tax Incentives for Small Employers of Activated Reservists

Current federal tax law offers employers in the private sector of military reservists no incentive to provide partial or full compensation to reservist employees, or to cover any difference between the military and civilian pay received by these employees, when they participate in active duty. Nor does current federal tax law give such employers an incentive to hire replacements for activated reservist employees.

S. 455. The bill would establish a new non-refundable business tax credit (under IRC Section 30C) for eligible small employers that employ military reservists. The credit would have two components. It would apply to any difference between the average daily compensation paid by such an employer to an activated reservist employee and his or her average daily military pay and

allowances while serving in active duty. The credit would also apply to the compensation paid by such an employer to individuals hired to replace activated reservist employees when they serve in active duty.

In the case of the former, the credit would be equal to 40% of any qualified compensation paid by an eligible small employer to a qualified employee in excess of his or her military pay and allowances. The credit would apply to any such excess up to \$25,000, which means that the maximum credit an eligible small employer could claim for a single qualified employee in a tax year would be \$10,000. A qualified employee is defined as an individual who has worked for an eligible small employer for at least 91 days before being called to serve in active duty and is a member of the “Ready Reserve of a reserve component of an Armed Force of the United States.”

In the case of the latter, the credit would be equal to 40% of a qualified replacement employee’s compensation during the period he or she replaces an activated reservist employee, up to \$15,000. This means that the maximum credit an eligible employer could claim in a single tax year for a qualified replacement employee would be \$6,000. A qualified replacement employee is defined as an individual who is hired to replace a qualified employee while he or she participates in active duty.

An eligible small employer is defined as any firm with an average of 100 or fewer employees on business days during the current tax year that provides compensation “under a written plan” to qualified employees above their military pay and allowances when serving in active duty.

Qualified self-employed taxpayers would also be able to claim the credit. In their case, the credit would be equal to 40% of the amount by which their average daily self-employment income exceeds the average daily military pay and allowances they receive while serving in active duty. Once again, the credit would apply to any such excess up to \$25,000. A qualified self-employed taxpayer is defined as a taxpayer who has net earnings from self-employment and is a member of the “Ready Reserve of a reserve component of an Armed force of the United States.”

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